

DOW THEORY LETTERS INC.

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Aug. 20, DJIA 974.07; PTI 675; A-D Ratio -23.31

Aug. 27, DJIA 963.93; PTI 663; A-D Ratio -23.70

CAPSULE PICTURE: (1) The D-J Averages sink below their July lows as the secondary trend of the market turns down. (2) The A-D Ratio cracks an eight-month rising trendline, thereby turning bearish. (3) Bonds, notes, bills, continue rising strongly as interest rates decline. (4) The second psychological phase of the bull market appears to be drawing to a close. (5) The forces of deflation surface as business slows down and consumers turn increasingly cautious. (6) Value becomes the key word in investment circles and the concept of "growth" fades. (7) The British market smashes ominously through its 365 support level, thereby wiping out all gains of 1976. (8) U S market now most oversold in months and beckoning a rally. But note (so far) upside breadth is unimpressive, downside breadth impressive.

THE PICTURE: History tends to repeat, but seldom in the same way. For instance, man goes through three stages, childhood - youth - and old age, yet no two lives are exactly the same. One fellow may grow out of childhood when he's 12, move into youth and stay there until he's 18. By the time he's 30 his friends will note that "Charlie looks like an old man." Another individual may not hit his youth until he's almost 20. He may remain youthful in appearance until he's 50, at which point he may be old in years but somehow never really looks like an older man. Thus, both men develop through the normal three stages of life, but the actual stages could not look more different.

Markets (both bull and bear) work in much the same way. As my subscribers know, bull markets can be divided into three fairly distinct psychological stages. As a rule, the three phases are separated by sizeable secondary corrections. In light of that, let's examine the last primary bull market, the bull market of 1949-66. The first phase represented the rebound from the depressed levels of the 1940's. That phase lasted from 1949 to 1953. In 1953 the market was hit by a major correction, following which the second phase began. The powerful second phase rise lasted from 1954 to 1956, and it reflected a steady improvement in business conditions. During 1956-57 the Dow formed a massive "triple top." The top was completed in July, 1957, whereupon the Dow dropped (corrected) 20% to a low in October of that year. So ended the second phase.

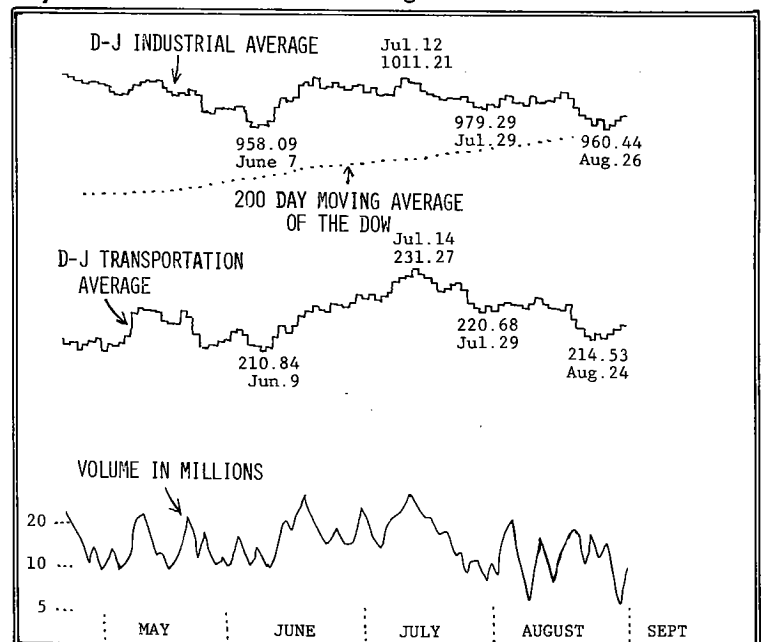
A severe business recession (still within the framework of the bull market) developed during 1958. But the market had already discounted the effects of the recession, and the Dow and most stocks climbed steadily higher throughout the year. All this occurred while experts and pundits complained that "Wall Street is crazy" and "the economy is headed for disaster." It didn't happen that way.

The year 1958 inaugurated the amazing and extended third phase of the bull market. That particular third phase was extraordinary in that it lasted from 1958 to 1966, (longer than the first and second phases combined). Actually, most bull market third phases are short and violent, but this 1958-66 affair was different. It was unbelievably long because it was "sponsored" by the US Government. And the cost of the third phase was phenomenal, a mountain of debt and full public acceptance of the philosophy of "buy now and pay later." The only problem was that the "pay later" part of the concept never materialized.

All right, now let's turn to the current situation. A new primary bull market was born amid the gloom and fear of the 1974 lows. The first bull market phase, the rebound from the depressed bear market lows, took the market up in a series of dramatic "buying stampedes" to the peaks of July, 1975. At that time I stated that the first phase of the bull market was ending. Stocks (as is normal during the first phase) had returned to "known values." The July highs were followed by an irregular correction which carried to the reaction lows of December, 1975. From there the second phase of the bull market began.

The second phase reflected the remarkable improvement in corporate profits as well as the rising liquidity ratios and the expanding consumer confidence. The second phase was ushered in by a new buying stampede which began in December, 1975. This explosive advance took the market to a peak in February, 1976. At this point, the picture grew slowly and subtly cloudy.

A series of non-confirmations and out-of-gear movements



carried to July, 1976, at which time the Dow rallied to close at a new bull market high of 1011.21. From there the market backed and filled, but it was increasingly apparent that the A-D ratio was stubbornly refusing to better its earlier (February) peak. On August 19 and 20 the market suddenly turned weak, and the D-J Industrial and Transport Averages plunged below their July lows. At the same time the A-D ratio turned significantly weak, sinking under its July low and breaking the trendline connecting the late-1975 and June, 1976 bottoms (see chart).

SECOND PHASE OVER? I am becoming increasingly convinced of something which I voiced in Letter 671, page 6, and that is that the second phase of the bull market is about over. I would say that the six months of divergent action (the "line" formation of February to August, 1976) corresponds roughly to the extended top of 1956-57. Those subscribers who have my chart albums (A-D ratio and D-J Averages) may find it worthwhile to examine the 1956-57 period in detail. Let's see how that second phase ended. During 1956-57, instead of a "line" formation such as the current one, the market traced out a massive "triple top" in the 520 area (the 520 level probably corresponds to the incredibly resistant Dow 1000 top of today).

In 1957 the A-D ratio hit a peak in January, sagged, then tried repeatedly to better the January high. Meanwhile, in a last desperate effort, the Industrials (July, 1957) made a final push to 520. But the Transports and A-D ratio failed by a wide margin to confirm. And that was it. By October, 1957 (three months later), the market was in shambles.

WHAT NOW? Where are we today, and what can we learn from 1956-57? As I see it, the technical damage sustained by the market during late-August was considerable. The D-J Industrial Average retreated to within a few points of its 200-day moving average, but Transports broke badly. The worst technical picture, however, is seen in the current pattern of the A-D ratio. In my opinion, this important index has broken so badly that it is going to take a thoroughly sold out market to get the A-D on a strong, upward path again.

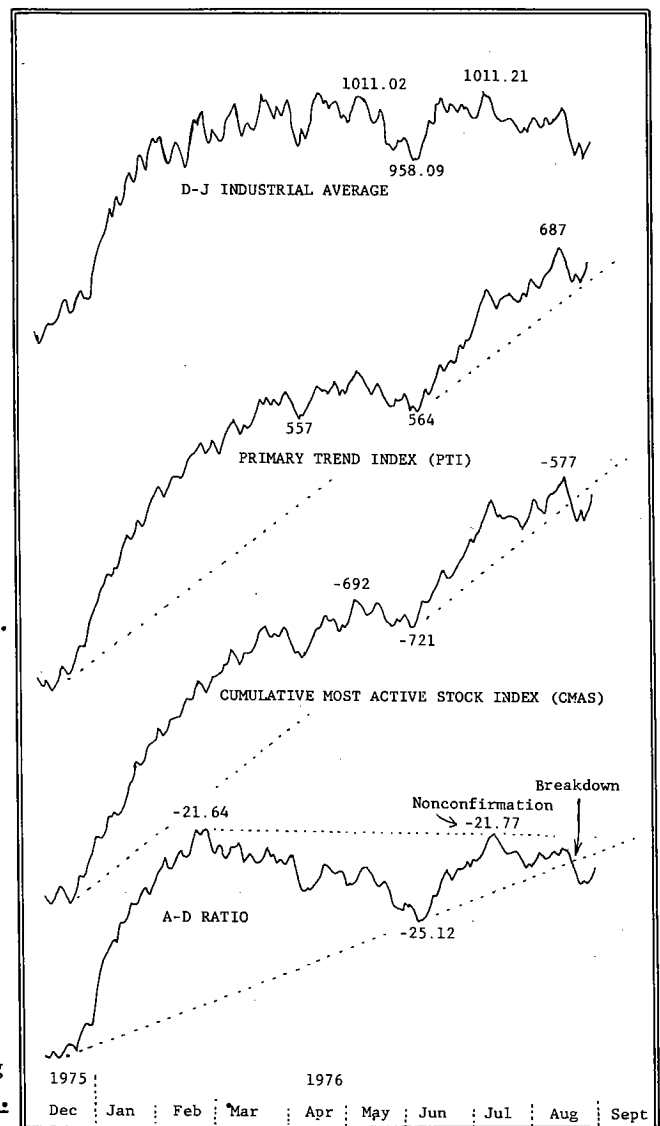
The fact is (and I have said this many times before) that this market has been faced with a buyers' strike for the past six months. Wall Street has been picnicing on bonds (with fat yields), it has been mulling over the possibilities of deflation, it has seen consumer confidence fizzle and it has seen business quiet down. Finally, the Street has watched Mr. Ford's inadequate performance as a candidate and it has been amazed with his choice of Mr. Dole as a running mate.

What usually ends a buyers' strike (such as this one) during an ongoing bull market? I would say that the thing which brings buyers in following a long period of disinterest is lower prices and bargains. Therefore, it appears to me that the current stalemate situation could drag out longer, but the market is saying that the second phase of the bull market is nearing its end. Whether a business recession is fated to arrive (as per 1957-58) remains to be seen. Perhaps we will get away with nothing more than the present slowdown, and that would be fortunate indeed (as those who went through 1957-58 will testify). At any rate, my guess is that some important adjustments are now blowing in the wind. The market has been dropping us hints about it for many months.

THOUGHTS: Anthony Boeckh of the authoritative Bank Credit Analyst has presented studies showing that it has required (since 1949) steadily increasing infusions of bank credit to produce each new dollar of Gross National Product. This, of course, presents a terrible dilemma for the Government and particularly the Federal Reserve Board. As these mounting infusions of bank credit were injected into the system, the forces of inflation were fired up. The fires continued until today the problem of a flare up in inflation is about equal to the problem of impending deflation. In other words, what nobody wants to face has finally come to pass. The US must now either inflate or slump. It's simply a question of choosing which one we want.

The fact is that at some point, the forces of inflation (on a very long-term basis) always give way to the forces of deflation. It is my feeling that we are now in the "no man's land" between inflation and deflation. Many things point to that conclusion: the collapse in golds, the sudden break in commodity prices, the sluggishness of business, the persistence of high unemployment, the steady rise in the bond market.

The American people have tolerated inflation for a long time. But the pendulum is now swinging away, and deflationary forces are showing themselves. I believe that Americans are so sick of inflation that they may well tolerate deflation and unemployment to an extent that the politicians do not yet recognize.



Nevertheless, deflation is going to bring about new problems. I feel that the new deflationary forces are going to be as sticky and persistent as the inflationary forces have been, and one of the first problems that Washington is going to have to face is how to get the economy climbing again (or even holding level). In my opinion, it is not going to be easy.

This is what may occur. A sluggish or even receding business picture between now and election time is going to hurt President Ford. It may well serve to knock him out of the box and bring Carter in. Carter will immediately opt (as he said he would) for increased spending and expanded employment. He will put the pressure on the Fed to start the pumps going. Chairman Burns will quit the Fed (as he stated he would if Carter is elected). Without Burns the backbone of the Fed could turn to rubber. The Fed would then be quick to oblige the new President. Consequently, the money will flow, interest rates will be brought down hard, and the Congress will reverberate with new make-work spending programs. Within this context, the bond market could extend its gains in dramatic fashion. All of this will represent the fuel which will bring about the ultimate third phase advance for this bull market.

But remember, it is going to take a huge amount of new bank credit to produce less and less in the economy. Thus, there is a strong probability that the first Government efforts are going to be below what is needed. This initial "moderate effort" will not be enough to get the economy rolling, and it will not be enough to start the stock market up. The actual amounts of bank credit needed to heat up the economic boilers are going to be shocking to behold. Therefore, the 1976-80 period is going to be very different from 1958-66. And just as 1958-66 produced its share of surprises, 1976-80 will present us with its full share of eye-openers.

Along these lines, I have just been reading the latest report of S. Jay Levy (Industry Forecast, Box 26, Chappaqua, NY 10514). Mr. Levy, who has a remarkable record of being right, predicts that "the United States is entering one of the most prosperous periods in its history." Mr. Levy notes that the US faces the problem of providing a huge number of jobs (about 11 million) during the next four years. This is another way of stating what I have written in previous paragraphs, and that is that the Government is heading for a big spending effort (plus monetary expansion) in the years ahead.

Of course, I've presented the foregoing in a pretty simply and "pat" way. But I have a problem, and that is that I basically deal with the market, not the economy. And when you deal with markets, you are also dealing with TIMING. People who read Dow Theory Letters may be interested in the information and the concepts and some of my occasional rambling. But what they really want is timing. So my feeling is that we are going to have difficult markets between now and the beginning of the third phase of this bull market. And I think we may see the Government and the Fed push and push mightily before the economy and the stock market respond by moving out on the upside.

But when they finally do move, it's going to be quite a show. If I had to guess based on what I see now, I would guess that this market could rally once more in a final display of pseudo-strength, fail, then slide into a decline that might not hit its low until late-October or November. From there (and that takes us to or even after the election) we will form the base for the third phase.

QUESTION: Russell, you've presented a very interesting scenerio. But if the Fed has to open the monetary floodgates to get the economy rolling, what about all these bonds you have us holding? Won't they decline as the Government starts the inflation fires again?

ANSWER: Sure they will. And there again we have a task of timing. I expect to see a lot of talk and excitement in bonds in coming months (perhaps even in the next year or so). And just about the time everyone is telling us what a marvelous deal bonds are, I will probably be telling my subscribers to sell all money instruments. But right now, there is still an approximate 4.8% yield spread in favor of bonds over stocks. From the standpoint of value, bonds are a premier investment at this time.

Here's another thought. A bull market usually provides one or two good buying spots each year. The last excellent buy-spot appeared around August, 1975 about a year ago. We have not had a really advantageous buying area in 1976. Therefore, the odds increasingly favor an outstanding buying opportunity for common stocks during late 1976 or early 1977. And remember this, the great buy-spots occur near correction lows, and as a rule the more severe the correction, the more advantageous the buying area.

QUESTION: What about the near-term? What do you make of the most recent action?

ANSWER: All right, please turn to the page 1 chart. Note that the Averages penetrated the July lows on very dull volume. In other words, there were no signs of increased selling pressure as the July lows were jointly penetrated. This is usually the prescription for a rally, and as this is written the Averages are pushing up, again on unexciting volume. We now have a double set of downside points to watch, and these are the June and the slightly higher August lows.

Since most readers are now in a somewhat defensive position, I don't see the point in getting any more defensive unless the June lows are now broken by both Averages (June lows are 958.09 for Industrials, 210.84 for Transports). And once again I'll remind readers that under Dow Theory the indications of a single Average are never accepted as valid. Therefore, I would want to see the June lows broken by both Averages before turning more cautious than I am now.

QUESTION: What about the other indicators?

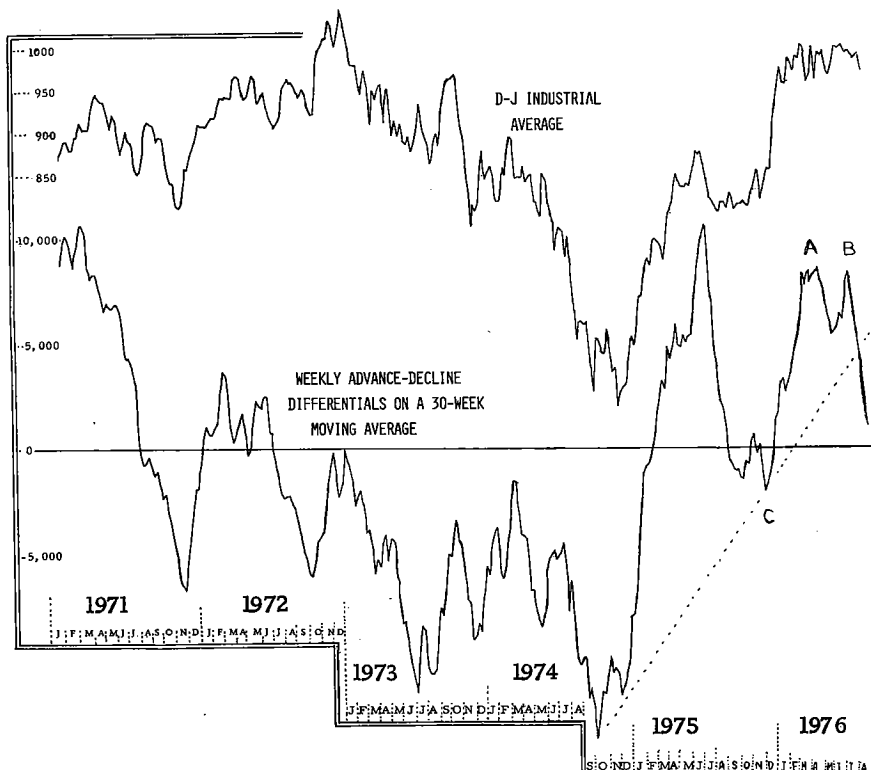
ANSWER: All the major Composite Averages have broken their rising trendlines. Thus, the bull market's rate of advance has definitely slowed down. Over the past week the cumulative most-active stock index (see page 2 chart) has broken a trendline extending from the December, 1975 low. The PTI is still holding above its trendline. The advance-decline line sank below its July low and is now moving up under its trendline. In all, a less-than-inspiring picture.

Page 4 **LONG-TERM BREADTH:** Each week I compute the differentials between advances and declines

(using the weekly figures provided by Barron's) These figures are then arranged in the form of a 30-week moving average. That long-term "breadth line" is shown on the accompanying chart for the period of 1971 to the present.

Any time this breadth line is above zero, it means that the 30-week accumulation of advance-decline statistics are on the plus side, and the converse is true whenever the breadth line sinks below the zero mark. But more important than the actual position above or below zero is the trend of the 30-week moving average of advances and declines.

Note that in early 1971 the breadth line (BL) hit a peak above 10,000. The BL then plunged below zero to minus 6800, then rose briefly above zero again to plus 4000. All during this period the Dow whipped up to successively higher peaks, the final one being the all-time high of 1051.70 (January, 1973). The point to note, however, is that the 1972 to January, 1973 advance was accompanied by declining action on the part of the BL. Thus, the 1972 move was deceptive and generally unprofitable for investors.



The last up-thrust by the BL in late 1972 succeeded only in taking the BL back to the zero line. This terribly weak performance gave way to the 1973-74 crash. The great collapse saw the BL drop to the minus 14,000 level, the lowest level in a generation.

From the late 1974 low, the BL exploded up above zero to a peak of 10,500 in July, 1975. The action from that point on is of vital interest to us today. From the July, 1975 peak, the BL broke under zero to a December low of minus 2000 (C on chart). The BL next rallied to a high of plus 8500 in May, 1976 (point A on chart). A mild drop into June followed, and then a new rally to a July peak of 8300 (point B).

On the week ending August 13 the BL dove to plus 4000. As you can see on the chart, this drop broke the entire rising trendline formed by connecting the 1974 and 1975 reaction points. Since then, the BL has sunk very close to zero. I interpret this action as indicative of significant weakness. It does not preclude forthcoming upside action and a third phase for this bull market. But it implies that we could have a good washout first. What I want to see now is whether the BL can hold persistently above the zero line. If it does not, I will be watching to see whether it at least holds above the December, 1975 low (C on chart).

If the BL breaks below zero, then below point C, I would say that we have almost surely seen the end of the second phase of the bull market. In that event, I would expect the BL to plunge deeply into minus territory. But I would personally be shocked if the BL gets anywhere near the 1974 low of minus 14,000 before this bull market is over.

VANCOUVER: We just returned from a three-day, whirlwind trip to Vancouver, British Columbia. We spent the days (and nights) with Dr. Harry ("a nation a month") Schultz. And during one evening we were the guests of Harry Browne, author, lecturer and opera-lover (he must have 5,000 opera records). In all a very fine three days, enjoyable, instructive and wearing. Since I had not seen the Schultz in 13 years, it was also a festive reunion.

Vancouver is the third largest (in population) city on the entire western coast of North America with a population of well over a million. It is clean, international in flavor, outstandingly beautiful and reminds me in many ways of NYC in the 1940's. Vancouver has space, huge lovely parks, and people who love to grow flowers. You see plants everywhere, in the houses, on the houses, in the yards, all over the parkways, and in every window sill. I guess I've never seen so many potted plants in my life. Schultz tells me that only the Dutch rival the Canadians as plantophiles. And if any place, anywhere, possesses a park which "out beautifies" the Queen Elizabeth Park in Vancouver, I'd love to hear about it (I thought our huge Balboa Park in San Diego was unrivaled—but forget it).

Vancouver boasts remarkably clean streets, and I mean spotlessly clean. For a big city, this is extraordinary. There are almost no blacks in Vancouver, and strangely almost no expensive cars. We saw two Mercedes while there, both with California plates! In Southern California, of course, you wade through oceans of expensive and exotic four wheeled vehicles. The thing I miss in Vancouver is news. The newspapers are a mess of features, local trivia and pictures. The radio stations supply little real news. As far as financial news, very little, and almost nothing regarding the NYSE (a situation which always drives me up the wall).

Canada's prices are surprisingly high and inflation is on in earnest. We paid twice as much for a breakfast, for instance, as we do in San Diego (where prices are low). But the food is outstanding. The great salmon steaks are much in evidence as is every kind of French and Chinese cooking (Vancouver has a giant Chinese population). Schultz eats like a bird and I chided him for his general disinterest in food (but we made up for it). But alas, I also have to report that my impression is that eating is the West Canadian national pastime. I have never seen so many overweight people, nor so many good restaurants in a town this size. Extra-sized belts should be a good business in Vancouver.

I also have to report that Canadians seem rather inefficient. We got messed up at the airport, the hotel was too hot, and Harry Browne showed us a large bathtub which had sprung a leak and which he said had been under "repair" for over six months. I also had the impression that Canada is growing into a super-welfare state. No one seems to want to work very hard or very much. On Sunday, the place is locked up tighter than a drum.

Aside from much personal conversation concerning the advisory business (which Schultz and I concluded had suffered a violent upheaval in 1975-76), we discussed gold, and I said that my experience in bear markets (and gold is in a bear market) is that they generally go further on the downside than the experts think they will. Schultz is thinking that \$90 could be the bottom, and my observation didn't make him any happier.

Schultz noted that N. Americans in general lack maturity and that one had to go to Europe to find maturity. I told him that such may be the case, but the US was the seat of power for the Western World, and that frankly, I felt that power was both fascinating and crucially important. The US, I held, was the hope of the West, and come what may, I was committed to "fighting" for what I thought was right, and fighting for it here in the U.S.

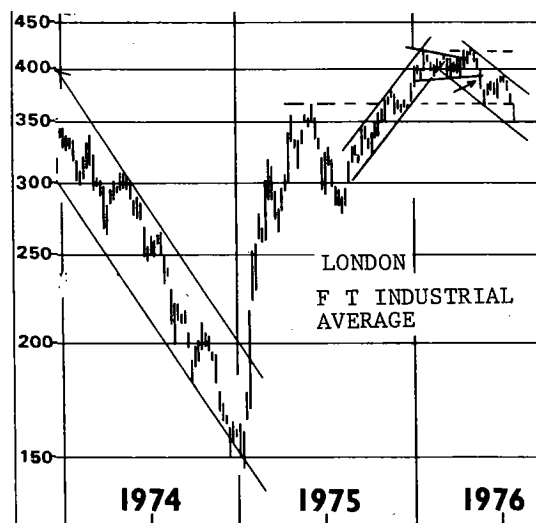
Browne, Schultz and I discussed the concept of possessions, and I think that we agreed that too many possessions can make a man a slave of what he owns. As the Kristofferson song goes, "Freedom's just a way of saying, nothing's left to lose." When a man has nothing, then the state can't take anything away from him (except his life). Maybe at some point, we will all have to lose everything in order to be free. After all, we came into this world with nothing, and I never knew anyone who took anything with him when he left this world. So possessions (as Shakespeare noted), are things which we "borrow" on the journey between life and death. And then again, poverty is the only real "protection" against inflation, expropriation, confiscation and high taxes. I noted (to everyone's amusement) that poverty may be the U.S. fad of the future.

I felt that Browne and Schultz are very concerned with the concept of the state's power over the individual. I am concerned, but somehow I'm not pulling my hair out about it — yet. In the final analysis, I think the great thing about money is that it allows you a measure of freedom from other people and from their social "rules." It also allows you freedom from drudgery and boring jobs and in many cases from situations that you don't want to be in.

SUNDRY: On the deflation front, I would put this week's rescinding of the US Steel price hikes as the number one item. I doubt that US Steel did this out of the goodness of their hearts.

I just received the September issue of the Bank Credit Analyst, and Editor Boeckh states that "for the time being, fears of an excessive expansion of the world's money supply are likely to prove unfounded. Rather, the more realistic worry is the one of contraction." Boeckh also notes that the drop in the gold price is deflationary since it shrinks world central bank reserves.

The London market is coming somewhat unglued. Britain's economy is weaker than the US economy. Therefore, their market often tops before the US market, and the US market usually bottoms before the British market. Last week the London Average fell out of its "head and shoulder" top and through the 365 support level (see chart). The London market is now looking rather ominous, and although this may not necessarily be bearish for Wall Street, it most surely isn't bullish. It's just a situation I could live without, and I'm presenting it to subscribers for what it's worth. (Chart courtesy of Ian McAvity's Deliberations.)



The Consensus of Insiders notes that mutual funds have dumped over \$5 billion in securities in less than five years. It also notes that fund cash is now near an all-time low at only 5.5%. Therefore, we can expect very little fund buying of stocks in the foreseeable future.

I am watching the 91-day bill rate carefully. I keep a daily chart of this with a momentum line. The momentum line shows yields holding to a trendline which starts at October, 1974. The trendline is very near being penetrated. If this occurs, short-term interest rates should drop precipitously. I feel that we are close to such a drop, and it is possible that it could be set off by a notch down in the prime and discount rate.

According to the Money Manager, if Ford is elected he is thinking seriously of appointing Nelson Rockefeller as Secretary of State and David Rockefeller (of Chase Manhattan fame) as, are you ready for this, Secretary of the Treasury. I've asked myself this many times before, but here goes in print, "Is this nation fated to survive?"

STORY: As I look at the seven items on this chart, I feel that they are telling us a story. In this business, most of us analysts indulge in fantasies regarding what we think the market and the economy "will do." That's the "ego trip" side of it. Then we have the charts, and they tell us what is actually happening and maybe (if we extend trends) what may happen in the period ahead. When our scenarios clash with what the charts are saying, it's usually very hard to believe the charts at the expense of our inflated egos. But my experience has been that when the charts clash with your scenario, you're either wrong on your whole concept or you're wrong on your timing. Either way, you're going to be wrong and you're going to cost people money. And that's the downfall of many an analyst; he stands on his ego and his personal scenario (in opposition to the facts that the charts portray). RIP, ego trippers.

Back to the chart; here we see the Dow moving sideways as if it can't make its mind up. And I don't think it can—yet. Inflation or deflation, that is the question. The Utilities and Bonds are in uptrends, and this suggests lower interest rates and declining inflation. The Treasury bill yields corrected during mid-1976 and appear to be heading lower again (they are inverted on the chart).

The Swiss franc remains strong, but it is not climbing against the dollar any longer. The fact is that the dollar has been acting quite well of late, and I rather think it's going to continue strong. Finally, we get to gold bullion quoted in dollars and the Barron's Gold Average (heavily weighted for ASA or S.African shares). Here again, the falling gold items suggest a decline in inflation or even a certain amount of net deflation. So all in all, the seven indices seem to be saying, "Even keel, a lessening of inflation, and little or no interest in gold or other inflation hedges." If you are thinking of another scenario, you may well be right, but you might also recheck your thinking.

HOW TO: Many subscribers have written to ask the how and what of bonds. I don't want to go into great detail, because that's your broker's job, but I can go into some of the broad categories. In the tax exempt area, you have the individual bonds and the bond funds. For the average investor, I prefer the diversification and liquidity of bond funds, and here we have the unit trusts and the open-end mutual funds. The new Kemper Municipal Bond Fund yields around 6.5% and is managed. This is a mutual fund. Then we have the unit trusts which are separate collections of Muni bonds placed into a trust and sold, usually in units of \$1000. These can yield around 7% (tax free) and they are not managed. Thus, the fund pays no management fee and there are no changes in the portfolio. Examples of unit trusts are the Nuveen series, the Municipal Investment Trust Fund (Merrill Lynch and others), Hutton Funds, etc.

In the taxable bond fund sector, we have the unmanaged unit trust again, usually sold in units of \$1000. Many of these are put out by leading brokerage houses such as Paine, Webber and Merrill and Hutton. Next we have the open-end bond funds such as Keystone-Custodian and Rowe Price New Income. These are managed, sell at net assets (plus commissions) and are otherwise like any other mutual fund. Finally, we have the closed-end bond funds which are listed on the exchanges. They are traded just like stocks. They often sell at a discount from actual net assets, they are managed, and they charge a management fee. Examples of these which are listed on the NYSE are Excelsior, Standard & Poor's Intercapital, Pacific American, Mutual of Omaha, Transamerica. Most of the taxable bond funds (both unit trusts and closed-end now yield around 9%, while the open-end funds yield nearer 8%).

For the nearest thing to total safety and liquidity, of course, there are US Government bonds and notes. Because they are so liquid and safe, they also represent the nearest thing to a pure interest rate "play." Many traders take large positions in these on margins as low as 10% down (but I don't recommend this for anyone but the professional). I include the chart of Transamerica Income (closed-end bond fund) as an example of recent action. Those who bought it a year ago (when recommended) now have a profit of about 15% plus 9% income, not too bad (chart courtesy of Quote, PO Box 213, Wichita, Kansas 67201).

Next Mailing: September 15

